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- Understanding how to read market makers' true intentions

• **Main Points:**

- Market makers' (mm) primary obligation is to their client accounts; they often buy or sell large quantities of a given stock ('work an order') and need to disguise their actions.
- Market makers' secondary role is to "make the market" in the stocks they trade, providing liquidity by buying and selling within a given 'trade box' from 2-6 spreads wide.
- As daytraders, we can profit from learning how to read the intentions of one or more market makers by seeing patterns in the level 2 window (eg., number of times they are at the bid vs ask, when they flip, how many times they refresh).
- Learning how to trade on the side of the primary market maker can be profitable, learning how to avoid trading against the ax is important.
- Some market makers are "bigger" (better capitalized, trade more share volume) than others, and you should pay more attention to these big players (MSCO MLCO SBSH GSCO etc.). Identify the main mm's for your stock with [this link](#).
- Market makers frequently disguise their order flow buy buying and selling on the ECNs like ISLD, ARCA etc. - therefore, watching the action on "ECN buying/selling" vs "Big MM buying selling" is an important skill to develop as well.

There are 3 main Market Maker trading actions you should learn how to read on a level 2 screen for a specific mm:

- **BUYING IN SIZE**
- **SELLING IN SIZE**
- **'GRINDING'** (making the market)

Let's look at how each of these works, and how to profit from it:

Examples:

You have to understand how this whole system works before learning how to daytrade within it. I'm going to take the market makers' perspective first, to show you how these guys deal with the stocks they trade, then show you how to profit from it. This whole market maker section takes up 3 different lessons, starting with this one.

Example #1 - BUYING IN SIZE: Let's say you're a market maker working for MLCO and you're working WCOM again today. You get a new client order to buy 250K shares WCOM for your client, a mutual fund manager over at Vanguard. Your performance is measured, in part, by your ability to buy near the lower end of the

Are you going to just jump on the ask and buy up 250K shares? No, you'll run the price up 2 points in the process and buy up for your client at the top of the day. They won't be calling MLCO to work WCOM any more, and MLCO's trading desk director won't be happy with you.

Let's say the level 2 chart on WCOM looks like this:

- **First**, ask yourself "where is the trade box for the market maker I'm watching"? In other words, what price is he willing to buy stock at, and what price is he willing to sell stock at?

Answer for MLCO: Trade box is inside the market at 77 bid WCOM, outside at 77 1/8 ask WCOM. Notice he's on the inside bid and one spread out on the ask (yellow band for bid, green band for ask).

WCOM		Best Market		P	T	OK
WCOM + 77 1/16		b 77		a 77 1/8 215 x 17		10.7M 15:25
MMID	Bid	B...	MMID	Ask	A...	
MASH	77	214	INCA	77 1/16	17	77 1/16 100
SBSH	77	77	NFSC	77 1/16	7	77 1/16 100
MWSE	77	68	ISLD	77 1/16	7	77 1/16 2.50K
ISLD	77	57	COST	77 1/8	10	77 1/16 300
MADF	77	52	MLCO	77 1/8	10	77 1/16 100
BRUT	77	46	PWJC	77 3/16	1	77 1/16 100
PERT	77	36	OLDE	77 1/4	10	77 1/16 300
LEGG	77	35	FBCO	77 1/4	10	77 1/16 100
MLCO	77	27	HRZG	77 1/4	2	77 1/16 100
HRZG	77	19	ARCA	77 5/16	22	77 1/16 200
PWJC	77	17	SLKC	77 3/8	10	77 1/16 100
GSCO	77	10	MSCO	77 3/8	10	77 1/16 100
NITE	77	10	JPMS	77 3/8	1	77 1/16 100
ARCA	77	10	SBSH	77 7/16	10	77 1/16 100
BTRD	77	10	DLJP	77 7/16	10	77 1/16 100
COWN	77	10	MASH	77 1/2	3	77 1/16 100
DLJP	77	10	NITE	77 9/16	10	77 1/16 100
SWCO	77	10	PRUS	77 9/16	1	77 1/16 100
PRUS	77	9	SHWD	77 9/16	1	77 1/16 100
FCAP	77	9	SALI	77 5/8	9	77 1/16 100
AGED	77	8	AANA	77 5/8	1	77 1/16 100

- **Second**, look at the order flow on Time & Sales: what's the pattern you see? A string of transactions going off mostly at the ask is bullish, at the bid is bearish.
- **Third**, look at whether the market maker is "holding the bid" at a certain price level (bullish) or "holding the ask" (bearish). In other words, let's say in this L2 box sellers using INCA (Instinet) don't budge from 77 1/16 and you see well over 10K shares being sold at 77 1/16. If the bid tier at 77 starts to evaporate (as buyers realize there's a lot of stock being sold) then the price will drop. This is why T&S is so important, the levels may be fake since the mm can refresh or buy/sell thru an ecn to cover his tracks. **T&S is so much more important than the**

Ok, back to our MLCO WCOM example. MLCO may in fact be buying stock through ISLD, and may fade his ask by a level or two if sellers start to fade. He may be sitting out the action for now, waiting for a more favorable entry.

Daytrader's Play: The lead MM who is buying in size may go short and sell some stock either directly or through an ECN to push the price downwards initially, then buy a bunch at the bottom, working his order up.

We play it by carefully watching several things:

- The **number of refreshes** at the inside bid vs inside ask (eg a mm is showing 10 bid (1000 shares) but we see him buying 13K shares in T&S).
- The **technical indicators** on our 1-minute chart (stochastics, RSI, previous support/resistance levels and volume).
- The **response from other traders** as they see what's happening. You may well get a bunch of buying (ever see a 'volume spike uptick?'). Don't chase at first, you should have entered when you saw the mm

color bands alone,
use them in
combination.

What else is useful? In
esignal, you can **highlight
specific market makers**, as
I have for MLCO, and see
even more info in T&S if
you wish.

Other software, such as
[Ensign](#), also gives you the
opportunity to **plot market
maker activity against the
stock price**. Some
programs let you see the
"number of times at best"
bid or ask for the market
makers playing a stock; a
good way to see net buying
or selling for the time period
you're watching.

Example #2: This time, let's say you're the market maker at SBSH and
you're working NOVL today. You get a new client **order to sell 700K
shares NOVL** for your client, a mutual fund manager at Fidelity.

- SBSH is in line sell
NOVL at 21 1/2, not in
a big rush here. How
do you tell? **In level 2,
your "order in line"
preference is
determined first by
the price, second by
the order size**. Now,
SBSH may want to
sell more NOVL than
all the mm's joining
him at the 21 1/2 bid,
but he's not going to
tell you that. MASH
gets first in line by
saying he's offering
out 107 (10,700
shares) at 21 1/2. It
means nothing. He
can drop that in the
blink of an eye, he is
only obligated to buy
the tier size on SOES
(which is 100, 500 or
1000 shares etc).
What counts is the

following one of these patterns
we've identified.

- **Ax flips/reversals vs headfakes:** if
MLCO suddenly disappears from the
inside bid (or 1-2 levels outside bid)
to the inside ask, he's telling
everyone he wants to sell. The
questions is, how much volume does
he sell? If its over 20K or so you can
be pretty sure he's not trying to fake
you out.

NOVL		Best Market		P	T	OK			
NOVL - 21 7/16 b 21 7/16 a 21 1/2 10 x 117 2:04M 11:10									
MMID	Bid	B...	MMID	Ask	A...				
DLJP	21 7/16	10	MASH	21 1/2	107	21 7/16	1,00K		
INCA	21 3/8	10	BRUT	21 1/2	53	21 7/16	2,00K		
WETH	21 3/8	10	NITE	21 1/2	22	21 7/16	500		
ARCA	21 3/8	10	INCA	21 1/2	15	21 1/2	200		
MASH	21 3/8	8	MADF	21 1/2	15	21 1/2	200		
SHWD	21 3/8	5	WPCO	21 1/2	10	21 7/16	1,00K		
ISLD	21 3/8	2	HRZG	21 1/2	10	21 7/16	100		
BTRD	21 3/8	1	SBSH	21 1/2	10	21 7/16	1,00K		
WPCO	21 5/16	10	GSCO	21 1/2	10	21 3/8	100		
REDI	21 1/4	25	PERT	21 1/2	8	21 7/16	700		
NITE	21 1/4	22	MWSE	21 1/2	6	21 7/16	700		
SBSH	21 1/4	10	PRUS	21 1/2	5	21 7/16	1,60K		
BRUT	21 1/4	2	FLTT	21 1/2	3	21 1/2	400		
SLKC	21 1/4	1	ISLD	21 1/2	2	21 1/2	300		
						21 1/2	200		

Daytraders' Play? What do you think,
gang? Well, we're on a downtick, so you
can't short it here right now (see the minus
sign in the upper left corner next to NOVL in

refresh rate that you observe in T&S, along w/traders' responses.

- This looks like a bearish level 2 chart, confirmed by the frequency and size of trades going off at the 7/16 in T&S. You'd have to watch the tape for a minute or two to get the feel for the momentum in the stock.
- Please note that most level 2 chart buying and selling is not as obvious like these two L2 charts appear; typically you'll see inside levels of 2-5 mm's wide. You need to pay attention to # of refreshes in T&S. Tape reading is how to daytrade successfully. For example, when do you see "the tide turning" and trades going off in between the bid/ask? (especially for net stocks like DCLK YHOO AMZN). This indicates potential reversals.

the dark green band?). If you've been following NOVL and know that SBSH is the ax (which he usually is, by the way), then you might want to join SBSH's bid at 21 1/4 for the stock (LIMIT BUY NOVL bid 21 1/4).

Ok for the "A" students, lets say 21 1/4 is a support level, and you think the price will bounce hard off 21 1/4 and give you at least 1/4 point scalp on the rebound. **How do you frontrun SBSH and buy before he does?** (which will run the price back up before you can get in?).

Answer: Don't bid up higher than 21 1/4. Don't wait til it bounces off 21 1/4 and you have to enter at 21 3/8 in the middle. **Bid 21 1/4 size 11.** That will put your bid in ahead of solly and behind NITE/REDI. If you could get a short off here ahead of the 21 1/2 wall of selling that would be great, but it's unlikely. Again, use 1-minute chart TA to help identify support/resistance and trend info. in addition to level 2.

Example #3: Today, it's a choppy low-volume day on the street, not much market direction. But, you still have to make money for Mayer Schweitzer, MASH, your employer. You have to make the market by **grinding out 3/8's**; buying at the bid and selling at the ask for AMZN a few spreads/levels up all day. It's boring, but you make money doing it consistently. As MASH's AMZN market maker you need to correctly set the limits of your "trade box" based on volume, price momentum and technical indicators.

Again, **identify the market makers' "trade box"** to see where he is playing it. Make note of what causes him to back off or lift stock at each level. Eg, is there a time of day effect (I find may axes often sit out lunch and fade a few spreads in either direction, or

AMZN	Best Market	P	T	OK					
AMZN - 91 7/8 b 91 7/8 a 92 10 x 27 10.5M 14:50									
M...	Bid	B...	M...	Ask	A...		91 7/8	200	
INCA	91 7/8	10	ISLD	92	22		92	100	
MMWE	91 7/8	1	ARCA	92	12		92	100	
ISLD	91 13/16	6	MASH	92	10		92	100	
MASH	91 3/4	2	BRUT	92	6		92	400	
NPSC	91 3/4	1	INCA	92 1/16	10		92	900	
MADF	91 3/4	1	DKNY	92 1/16	1		92	100	
REDI	91 9/16	5	REDI	92 1/8	2		92	100	
SELZ	91 9/16	1	MLCO	92 1/4	9		91 15/16	600	
UPMS	91 1/2	1	MMSE	92 1/4	5		91 15/16	100	

bid it down to buy for an afternoon run).

To grind a stock by following the ax,

simply trade like he does: join his bid if he stays there through 5K-10K or more shares of buying (perhaps front run by 1/32 or a size increase); as soon as you have a trade confirmation then offer to sell it at the price level he is at.

Note that you have to be able to fade and lift like the mm does in order to scalp using this method. So, a professional direct access broker like cybercorp.com or mbtrading.com is recommended, so that you can immediately sell or cancel your bid with rapid speed. The ax will drop his bid if he sees a lot of selling pressure, and you need with speed. Waiting for a browser-based broker to give you confirmations etc. is probably too slow for this type of trading.

91 1/2	1	SLKC	92 1/4	1	91 15/16	100
COWH 91 1/2	1	SLKC	92 1/4	1	92	100
SLKC 91 7/16	1	MONT	92 1/4	1	91 15/16	100
MSCO 91 1/8	10	NITE	92 1/2	20	92	100
STRK 91 1/8	5	MADF	92 1/2	11	91 63/64	100

Ok, what's MASH doing here? His trade box is outside bid 91 3/4 size 2 by inside ask 92 size 10. What's he doing? Offering stock out here. Which is a good idea, whole number resistance is a good place to park your sell orders to see if you get a sell.

What would you do? Since there's a lot of sellers at 92 I'd wait until the bid firms up a bit more before entering a bid (or, you could enter a bid far away from the action, say at 91 1/2). Time and sales is bullish in this screen, as more sales are going off at the ask than the bid. It's a "indeterminate" or low-percentage situation here; I'd wait til you get better indicators before trading the stock. Grinding it with MASH would say, if you're already in from lower, than offer it at 91 15/16.